How to Think About Job Creation and Spending: A Primer

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ABSTRACT

According to many members of the public, the primary effects of various policies are their impacts on jobs. Mostly such arguments rest on whether it is believed that a policy will increase or decrease spending. Variations on this point can be heard in discussions of issues as varied as immigration, the minimum wage, policies towards corporations, and international trade. However, centering the discussion on the effect on spending is remarkably misleading, as other methods of optimizing the amount of spending in the economy exist. The economic effects of these policies must always begin with how they affect economic growth and efficiency, and any spending effects are wholly tertiary. Since such arguments span across the political spectrum, it is best to call a ceasefire, however intuitive the arguments appear.

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Introduction

The views of economists and the public diverge on what should be the centerpiece of economic policy. The public's mind is always on job creation – how many jobs will that bridge project create? How many jobs will a tax cut create? Economists think foremost about efficiency and growth – how can we produce greater creature comforts out of the scarce resources available? However, economists fully understand people want gainful employment and going without a job causes great individual hardship.[1]

This difference in emphasis is best understood by comparing how the public and economists approach policy issues. A common defense of the minimum wage, for example, is that it puts purchasing power into the hands of the public, which leads to more spending and therefore more jobs. The kernel of truth in this train of thought is completely understood by economists. But it's not the whole picture and probably overlooks the real economic implications of the minimum wage. For efficiency and growth, the question is whether we are using the optimal amount of labor in the correct industries and for the correct tasks. There are simply better ways of addressing inadequate spending in the economy.

Ultimately, economists bring more clarity to the debate. Whereas the public continues to conflate them, economists have done a better job separating the two competing issues. One is whether there is the correct amount of spending going on in the economy. The other is whether the rules we have in place lead to efficiency and growth. If the lack of spending is a problem for an economy, there are specific tools available to increase spending. After accounting for these tools, the question about whether increasing the minimum wage increases spending is simply beside the point.

This primer demonstrates the errors in the public's thinking about corporations, international trade, and immigration. It will clarify the public's intuitions of how these issues relate to spending[2] and offer an alternative, more constructive, perspective on how to best analyze such policies. The confusion that stretches across the political spectrum is incentive enough to clarify the arguments surrounding these issues.

An Example

One anti-tax argument is that business owners would hire more but the government taxes away their money. The small business owner looks at the money left over after accounting for his expenses and everything the tax man took away. If only the government hadn't taxed away so much of his income, he would have hired another worker, helping his business to grow in the process.[3]

But there's a lot wrong with this story. Let's say the business owner has a good idea of how many workers to hire, perhaps at his pizza shop. If he hires only one worker, the worker

[1] The manner in which the public continually emphasizes jobs over growth is ubiquitous enough for economists to see it as a bias of the public. See Bryan Caplan, 2007, *The Myth of the Rational Voter*, Princeton: Princeton University Press.

[2] In economists' jargon, what we are really talking about is "aggregate demand." We shall stick to the more intuitive term "spending" out of sake of clarity.

[3] See Robert Frank, 2011, *The Darwin Economy*, Princeton University Press for a more detailed description and dismantling of this argument. This citation should not be interpreted as an endorsement of other arguments presented in the book.

can't possibly get everything done and the business owner will lose money. If he hires 10 workers, workers won't have enough to do and will overcrowd the pizza shop. There is, however, a sweet spot where a certain number of workers which enables the business owner to make the most money. Let's assume that is five workers.

When considering whether we should raise taxes to pay for more teachers, what we should be asking ourselves is whether the improvements to efficiency and growth the teachers create outweigh the costs to efficiency and growth the new taxes create. The impact on spending does not belong in the discussion.

With those five workers employed, the income the business owner will receive is $100,000 before tax. If the income tax is 10%, he will make $90,000 in income after tax while employing those five workers. And what happens if the tax rates increase to 50%? His after-tax income is now only $50,000. *But it still makes sense to employ five workers*. That fact didn't change when the tax rate changed. If he employs fewer, workers, he will still make less money.

There are plenty of other ways taxes could negatively affect employment. Some taxes do actively discourage employment (e.g. payroll taxes). And, the income tax also has negative effects on employment through other mechanisms. But the notion that an income tax removes spending power from the employer and is the cause for his lack of hiring more employees is not what is important.

This still is only part of the picture. What happens when the government taxes a dollar? Presumably, it taxes so it can spend it on something else.[4] Why does that lead to less spending overall? There are subtle theories as to why one dollar taxed and then spent may later lead to more or less than one dollar in total spending. But if we make the assumption that it has no effect on overall spending, the act of taxation changes the type of jobs people will be employed in (public versus private).

This is wholly agnostic to how large the government should be. We should keep in mind that taxes themselves have a negative impact on efficiency and growth, at least typically. That is a fact. Those impacts need to be weighed against other impacts on efficiency and growth, for example in public investments in schools and infrastructure. When considering whether we should raise taxes to pay for more teachers, what we should be asking ourselves is whether the improvements to efficiency and growth the teachers create outweigh the costs to efficiency and growth the new taxes create. The impact on spending does not belong in the discussion.

But why does spending even matter?

This seems like a rather thoughtless question to non-economists. If people are spending more at the pizza place, *of course* the pizza place will want to hire more workers. But again, this is only piece of the story.

Before consumers began spending more at the pizza place, the business owner would have entertained the thought of hiring more workers. Perhaps the business owner figures it will be worth it to hire a worker at $7 per hour.

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4 If it does not spend it on anything directly, it is likely using the money to retire old debt, which is probably a good thing.

He tries to, but he can't find someone who is willing to work for less than $8 per hour. If people begin ordering a lot more pizzas, however, this changes. He no longer is willing to spend just $7 an hour for more labor. He's willing to spend maybe as much as $10. So when he finds out the workers still only demand $8 an hour, he hires them.

Most economists believe wages to be by nature downwardly inflexible.

This just opens up the question, why did the unemployed people demand at least $8 per hour? They wanted the job. The pizza place would have hired a lot more people already if the worker was willing to accept a much lower wage. This is true of pretty much any business, not just the pizza shop. If the wages go low enough, the business will find *something* for you to do. If workers just went around seeking the highest wage they can get, even if the wage is low, unemployment should be trivial and short-lived. That is the puzzle.

Most economists do not believe this to be the case. They believe wages to be by nature *downwardly inflexible*. For low-skilled workers, wages are inflexible by law i.e. minimum wage laws, but this is observable where the law is not binding. For example, we can observe wage inflexibility among salaried workers making $50,000 per year, not just among minimum wage workers.

If the business sees more spending, employees are happy to see more wages. However, if the business experiences a fall in spending, things aren't so simple. Studies have shown that, when given a choice between across-the-board wage cuts or layoffs, employees strongly prefer layoffs. So as to maintain morale, employers may acquiesce to these preferences.[5] The effects of this can be plainly seen in the data – there are very few nominal wage cuts each year, and a completely disproportionate number of employees continuing employment with zero wage change.[6] *But if there are layoffs instead of wage cuts, the optimal number of employees is no longer employed by the business*.

Workers do not like seeing their wages cut – does anyone? Yet in modern economies, workers must be directed from one sector of the economy to another. This can typically be performed ably with prices (i.e. wages). The rising wages at the pizza shop attracted those who might already be employed elsewhere because the business owner was willing to spend more on the wages. Think about the rapidly rising wages in North Dakota, which attract workers across the country to where they are needed most. This is representative of one of the ways a market economy is conducive to ensuring that labor is used where it is needed the most.

But a dynamic economy also has *shrinking* sectors of the economy, and in those sectors, the reverse must happen.[7] If the pizza shop is gaining customers at the expense of the falafel place across the street, the falafel place

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[5] Truman F. Bewley, 1998, "Why not cut pay?" *European Economic Review* 42 (3-5): 459-90.

[6] David Card and Dean Hyslop, 1997, "Does inflation 'grease the wheels of the labor market'?" In *Reducing Inflation*, ed. Christina Romer and David Romer, Chicago: University of Chicago Press.

[7] George Akerlof, William T. Dickens, and George L. Perry, 1996, "The Macroeconomics of Low Inflation," *Brookings Papers on Economic Activity*, 27(1): 1-76.

experiences less spending and has less use for its current workers. Just as the pizza shop should be willing to spend more on wages for workers, the falafel place should be willing to spend less. But because of the downward inflexibility of wages, it cannot.

This is why it is useful to think about not just the relative wages and prices among the pizza place and falafel place, but the *overall* prices in the economy. If it costs the typical consumer $105 to buy the typical bundle of goods this year that it cost her $100 to buy a year ago, we might say that overall prices have increased by 5%. But she is not necessarily worse off. A wage is a price, too. If her wage merely kept pace with inflation, it will have increased by 5% as well. In other words, if she had a wage of $10 per hour last year, it should have increased to $10.50 per hour this year.

Any talk about 'purchasing power' and the lack of sufficient spending in the economy to buy all the goods on the shelves must ultimately link back to downward wage inflexibility.

However, her wage may not keep pace with inflation. If her wage only increases by 3% while overall prices are increasing 5%, it means her "real" wage is cut – her wage can buy fewer goods in a tangible sense – even though she is receiving a greater "nominal" wage. "Real" wage cuts, those that matter for businesses like the pizza place, can therefore be achieved without running into problems with downward wage inflexibility. A worker may be disappointed with only receiving a 3% nominal wage increase, but the effects are not nearly as salient and depressing as a nominal wage cut, even if the real wage buys the identical number of goods.

This is the mechanism by which continually increasing overall spending may help keep more people employed. Discussions about spending which divorce themselves from how this affects real life businesses are likely to be poorly grounded in economic realities. Any talk about "purchasing power" and the lack of sufficient spending in the economy to buy all the goods on the shelves must ultimately link back to downward wage inflexibility. If it does not, it has little basis for affecting economic policies.

The only relevant policies for more spending

There are two policies which economists believe the government can use to manipulate spending and inflation in the economy. *Monetary policy* involves the central bank (i.e., the Federal Reserve) purchasing assets – normally federal government debt – with newly printed money. *Fiscal policy* has the government run a deficit in hopes that it will increase overall spending in the economy.[8]

"Printing money" sounds like a recipe for bad government, and many banana republics have found out the hard way what happens when you try to finance the public sector with inflation. But the whole idea, of course, is that there can be too little spending going on in the economy, and there's no cheaper way of increasing spending than by printing money.

Fiscal policy in the form of stimulus packages, using a combination of spending increases and tax cuts, are performed so as to

[8] These mechanisms are explained thoroughly in any introductory textbook in macroeconomics. For example, Tyler Cowen and Alex Tabarrok, 2009, *Modern Principles: Macroeconomics*, New York: Worth Publishers.

increase spending at times when economists believe that monetary policy alone won't do the job. There is general agreement that fiscal policy is less desirable than monetary policy, though economists are more split about whether the Great Recession of 2009 offered a firm basis for engaging in active fiscal stimulus.[9]

If there is enough spending in the state economy, there is no reason why jobs created by additional government spending will be in any way sustainable.

Together, these two means of increasing spending obviate any need for using other ways of increasing overall spending in an economy. To any extent that more spending can create more jobs, the discussion begins and ends with monetary and fiscal policy. Questions about the effects of minimum wage laws or international trade on spending are red herrings, plain and simple. Regardless of the level of spending going on in the economy, other laws must focus on what maximizes efficiency and growth and wholly disregard their impacts on spending. If such policies do lower spending, there are tools out there that can successfully counteract a shortfall.

Again, taxes and government programs may affect unemployment in the economy through other mechanisms. But the rationale for a tax cut to combat a recession should find its basis on how it might increase overall spending in the economy, not that higher income taxes make people less enthusiastic about staying in the workforce. Those concerns should be present regardless of whether or not the economy is in a recession. The framework for the tax system should be determined by its effects on growth and efficiency regardless of the state of the job market. A temporary tax cut may also lead to more spending during a recession and therefore more jobs. But that may be true of government spending as well.

Spending at the state level

While a lack of spending may be a problem in the United States overall, it is not automatically true that state and local governments should try increasing spending in their own jurisdiction. In some areas of the United States, enough spending is already taking place. North Dakota in the midst of its boom has the lowest unemployment rate in the country and would probably not create even more jobs if there were more spending. As of August 2013, the unemployment rate was 4.6% in Vermont, the lowest among New England states.[10] Stimulus undertaken in such states would accomplish exactly nothing.

It may be tempting for state legislators to act out of the belief that it will create more jobs if the government were to spend more. As I have argued elsewhere, this is wrong.[11] For

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[9] Compare J. Bradford Delong, and Lawrence H. Summers, 2012, "Fiscal Policy in a Depressed Economy," *Brookings Papers on Economic Activity* (Spring): 233-274; John B. Taylor, 2009, "The Lack of an Empirical Rationale for a Revival of Discretionary Fiscal Policy," *American Economic Review: Papers and Proceedings* 99 (2): 550-55.

[10] Bureau of Labor Statistics, "Unemployment Rates for States," http://www.bls.gov/web/laus/laumstrk.htm

[11] Ryan Murphy, 2013, "Fiscally Illiberal: State and Local Projects Cannot Create Jobs Responsibly," BHI Policy Study,

fiscal stimulus to even work in theory, it must be financed with debt. State and local governments cannot deal with large debts nearly as well as the federal government can, since the federal government can always pay off its debt by printing money. The disastrous results of attempting to run deficits without also controlling the printing press can be seen right now in Europe, and it is not pretty.

One other point is the fruitlessness of job creation projects in states that do not have a spending shortfall. If there is already enough spending in the state economy, there is no compelling reason why jobs ostensibly created by additional government spending will be in any way sustainable. Under these circumstances, states engaging in additional deficit finance will have more inflation and higher debt with no more total jobs to show for it. For instance, the work done on the Big Dig in the 1990s in Massachusetts primarily shifted labor and other resources from the private sector because there was no shortfall in spending many of those years.

If there is already enough spending in the state economy, there is no reason why jobs ostensibly created by additional government spending will be in any way sustainable.

It is theoretically possible for the federal government to increase overall spending by increasing its debt. Since state and local debts categorically differ from federal government debts, state and local governments should relinquish spending management to the level of government that can best deal with its costs. Moreover, in states where there is little evidence of a shortfall in spending, such as in states where unemployment is under 6%, fiscal policy will be pointless altogether.

http://www.beaconhill.org/OnTheIssue/Papers/StatesAreFiscallyIlliberal2013-0102RM.pdf

Applications

There are several arguments politicians and members of the public make about the negative consequences of too little public spending. But these arguments are unsubtle in many ways. Just as there may be too little spending sometimes, there may also be too much. And there is hardly an understanding that other tools should alone be used to control the path of spending in an economy. Regulations and policies besides these tools must focus on efficiency and growth. We will now go through a few examples.

Corporations

There is a general suspicion that corporations do less good for their communities than other businesses. In such a light they are viewed as predatory, for example WalMart. There are many aspects to this position that will not be addressed here. But one is that money does not stay in the community when it is spent at chain stores and the like.[12] A concern arises that, while money spent on local goods continues circulating and benefiting the community, a dollar spent at a multinational will be used to maintain a CEO's yacht, never to return. This has led not only to public pressure against corporations entering the community,

[12] Jeff Milchen, "The Multiplier Effect of Local Independent Business Ownership," American Independent Business Alliance, http://www.amiba.net/resources/multiplier-effect

but to private endeavors to keep money from "leaking" out of the area.[13]

Of course, the money does not disappear into thin air; if spending is reduced in one community, it will increase in another. The strongest version of this argument is therefore beggar-thy-neighbor – increase spending in *this* community at the expense of another one. Anti-corporation policies in the name of spending can only hope to help the locals by impoverishing outsiders. It is not obvious why such policies are desirable to begin with, since spending in this sense is a zero-sum game.

And the "locavore's" argument that corporations reduce spending by siphoning it off elsewhere is severely flawed. Suppose Japan sees that McDonald's is using the support of labor in the United States and purchasing many goods from the US as well. Money that would be spent and re-spent in Japan instead "leaks" into the United States. The correct way to combat this isn't to kick the multinational out of Japan or pass regulations requiring it to source its resources locally. The Bank of Japan has in its hands the tools necessary to offset any shortfall in spending. If Japan loses jobs due to the presence of the American corporation, the citizens of Japan should fault the central bank for failing to do its job, not the corporation.

International Trade

Economists have long been in favor of free trade, much to the consternation of the general public. Trade is the canonical example of differences in opinion between economist and public opinion generally.[14] If there is agreement among economists on any single policy issue, it is that tariffs should be zero and that the regulation of trade (outside of basic safety and purity regulations) should be eliminated. It is true that in the 1980s, some academic literature appeared outlining very specific circumstances where optimal tariffs are greater than zero appeared, but they were very rapidly misconstrued. Paul Krugman, whose work in this area won him the Nobel, has publicly and repeatedly denounced the use of this research as a basis for protectionism.[15]

No one disputes that decreasing imports and increasing exports will increase spending in the economy. So, in that sense, making the balance of trade more "favorable" can certainly "create jobs." But the way it would do it is the same as government spending hopes to – through inflation. This means that the romance of factory jobs and "Made in America" is tied to pumping up inflation in a very circuitous manner.

Think about it this way. Let's say overnight, half of America's remaining manufacturing jobs go overseas. Besides the need for a time of transition, this phenomenon does not lead to unemployment. The economy finds new things for people to do, just as it did when in the distant past workers transitioned from agriculture. The problem only arises if the "unfavorable" balance of trade turns into a fall in spending. Falls in spending are what monetary and fiscal policy should address.

[13] Consider private local currencies or some of the arguments used in the "buy local" movement.

[14] Caplan, ibid.

[15] Paul Krugman, 1997, *Pop Internationalism*, Cambridge, MA: The MIT Press.

After using the correct policy tools to combat any fall in spending, the effects of an increase in trade are clearly beneficial for efficiency and growth. Americans are able to find specific areas that they excel most at and leave other jobs to other countries. *Overall*, this is certain to lead to more wealth in the economy. It may be that people, whose skills were tied up in an industry that has moved overseas, lose in the deal, but theory and evidence tell us that this is more than outweighed by gains for others. Moreover, there are winners and losers in *every* public policy. The public just seems to notice more when it comes to trade.

Both F.A. Hayek and Milton Friedman understood the possibility that too little spending could have detrimental effects on the economy.

Immigration

Most economists believe that immigration generate positive economic benefits for natives, and at worse would have a neutral impact on the wages of current US citizens.[16] These positions are about the effect of immigration on efficiency and growth whereas, of course, most economic objections to immigration are about its effects of jobs. This argument too is ultimately about the effects of spending on the economy.

Assume a US worker is displaced by an immigrant. Previously he made $40,000 per year. Now some of that money goes to the immigrant willing to work for less than that. The rest stays with the employer. But the $40,000 doesn't disappear into thin air. The business earns greater profits, which beget greater income for someone else. Eventually that money will get spent.

But the ace-in-the-hole for the anti-immigration advocate is that, unlike for natives, the immigrant sends some of his income home as remittances. However, this money, too, should ultimately purchase American goods. If via the international marketplace it does not return to purchase American goods, it means citizens of foreign countries are gradually piling up larger and larger balances of US currency. This hardly seems like it's a raw deal for US citizens – we're effectively exporting slips of worthless paper in exchange for labor. The only way this is damaging if it causes a fall in spending.

Believe it or not, the solution to a fall in spending caused by currency leaving (i.e. remittances) is for the host country to print more currency. The Federal Reserve is keenly aware that foreigners like to use US currency instead of currency from their own country. It is also aware that a growing population – whether as a result of more native childbirths or immigration – requires the presence of more money in order to ease labor markets.

Immigration simply should not be expected to reduce employment of current US citizens unless monetary and fiscal policies fail to increase spending.

Are concerns about lack of spending fundamentally anti-conservative?

The two greatest inflation hawks of the 20th century were Milton Friedman and F.A. Hayek, both recipients of the Nobel Prize in economics. Each of these economists was

[16] For this and other arguments related to immigration, see Bryan Caplan, 2012, "Why Should We Restrict Immigration?" *Cato Journal* 32 (1): 5-24.

known to serve as inspirations to Ronald Reagan and Margaret Thatcher and counseled governments on how to curtail the Great Inflation in mid-late century. However, both economists understood the possibility that too little spending could have detrimental effects on the economy.

Milton Friedman literally wrote the book faulting the Federal Reserve for causing The Great Depression by not pursuing enough spending and inflation.[17] Late in his life, he endorsed a policy for the Federal Reserve that, if adopted today would imply that the Federal Reserve failed in its duties to maintain high enough levels of spending over the last five years.[18] Hayek's beliefs were less clear, although he eventually saw lack of spending as being of prime importance for the lengths and the depths of the Great Depression.[19] Calls for more inflation are not popular within the Republican Party at the moment, but two of its intellectual influences in economics certainly understood the importance of spending. However, these questions are addressed at the federal level. Programs which seek to increase spending at the state and local level are simply bad policies.

Discussion and Conclusion

The underlying arguments for many aspects of today's policy debates may be coherent, but they rest on the idea that too little spending in the economy may have negative consequences. Economists who have studied the issue find it painfully clear that it makes more sense to control overall spending in the economy with monetary and fiscal policy than to circuitously do so with policies regarding corporations, international trade, immigration, or the minimum wage. An argument that any of these may reduce spending in the economy is an argument for more monetary or fiscal policy, not regulation.

There may be other convincing arguments regarding immigration or the minimum wage. Those arguments are well beyond the scope here. The point is that opposing immigration because it will cause spending to leak out of the economy or that immigration will otherwise cause there to be fewer jobs for those born in America is simply wrong. These problems would not exist if monetary and fiscal policy were effective. The popular view on corporations, trade, immigration and living wages cannot withstand scrutiny in honest public discourse.

The benefit of these arguments for restrictive immigration or higher minimum wages is that they are politically popular. This is why politicians and pundits make them. But take notice that using such arguments yields that moral high ground to the opponent on other issues. Claiming that raising the minimum wage is good for the economy because it increases spending is no more or less true than claiming that an influx of immigrants sending remittances home can cause a collapse in spending. Either both may be damaging to an economy or neither is. It is dishonest or intellectually blind for public figures to claim that one is an important issue and the other is irrelevant.

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[17] Milton Friedman and Anna Schwartz, 1963, *A Monetary History of the United States, 1867-1960*, Princeton: Princeton University Press.

[18] Milton Friedman, 2003, "The Fed's Thermostat," *The Wall Street Journal*, http://online.wsj.com/article/0,,SB106125694925954100,00.html

[19] Lawrence H. White, 1999, "Hayek's Monetary Theory and Policy: A Critical Reconstruction," Journal of Money, Credit & Banking, 31(1): 109-120.

If monetary and fiscal policies are properly in sync with the state of the economy, boosting spending will yield no economic benefits. And for all practical purposes, politicians acting at the state and local level will do more harm than good by trying to manipulate the level of spending in their own fiefdom. The intellectually sound arguments must center on the effects of policy on efficiency and growth - the first concerns of economists - not the tertiary effects on levels of spending arising from other policies. Selective usage of spending arguments reduces the effectiveness of the polity. Governments which have fallen under their spell do their economies no favors.

The Beacon Hill Institute at Suffolk University in Boston focuses on federal, state and local economic policies as they affect citizens and businesses. The institute conducts research and educational programs to provide timely, concise and readable analyses that help voters, policymakers and opinion leaders understand today's leading public policy issues.

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